SUPREME COURT OF CALIFORNIA

Bily v. Arthur Young & Co.

3 Cal. 4th 370, 834 P.2d 745, 11 Cal. Rptr. 2d 51 (Cal. 1992) · No. S017199 · Decided August 27, 1992

SUMMARY

The California Supreme Court considered the extent of an independent auditor's duty of care to persons other than the audit client. It held that an auditor owes no general duty of care to nonclients, but may be liable for negligent misrepresentation under Restatement Second of Torts section 552 to persons in an intended transaction, and for intentional fraud to reasonably foreseeable third parties.

CASE DETAILS

COURT	Supreme Court of California
WRITING FOR THE COURT	Lucas, C.J.; Panelli, J.; Arabian, J.; Baxter, J.; George, J.
JURISDICTION	California
DECIDED	August 27, 1992
DOCKET	S017199
DISPOSITION	reversed_and_remanded
PROCEDURAL POSTURE	Investors sued the company's independent auditor for fraud, negligent misrepresentation, and professional negligence after relying on allegedly inaccurate audited financial statements. After a jury returned a verdict for plaintiffs on professional negligence, the Court of Appeal affirmed. The California Supreme Court granted review and reversed the Court of Appeal's judgment.
STANDARD OF REVIEW	Whether an auditor owes a duty of care to nonclient third parties is a question of law governed by policy considerations. The court also reviewed the legal sufficiency of the theories submitted to the jury and the effect of instructional error.
PRECEDENTIAL VALUE	Published California Supreme Court opinion; binding statewide precedent.
PARTIES	Arthur Young & Company, J.F. Shea Co., Inc., et al. v. Robert R. Bily, J.F. Shea Co., Inc., et al.

TOPICS

professional negligence · negligent misrepresentation · commercial litigation · torts

PRACTICE AREAS

torts · commercial litigation · professional negligence · negligent misrepresentation

QUESTIONS PRESENTED

1. Whether an independent auditor owes a general professional-negligence duty to nonclient investors and other third parties who foreseeably rely on an audit report.
2. Whether nonclient third parties may recover against an auditor for negligent misrepresentation under Restatement (Second) of Torts section 552.
3. Whether an auditor may be liable to reasonably foreseeable third parties for intentional fraud in preparing and disseminating an audit report.
4. Whether the professional-negligence verdict could stand when the plaintiffs were not clients of the auditor.

HOLDINGS

1. An auditor's liability for general negligence in conducting an audit of client financial statements is confined to the client who contracted for or engaged the audit. Merely foreseeable third-party users of the audit report may not recover on a pure professional-negligence theory.
2. A nonclient may recover for negligent misrepresentation in an audit report only if the auditor supplied the report for the benefit and guidance of the plaintiff or a limited, identifiable class, with respect to a specific transaction or type of transaction that the auditor intended to influence, and the plaintiff actually and justifiably relied on the report.
3. An auditor may be liable to reasonably foreseeable third parties for intentional fraudulent misrepresentations in an audit report when the auditor intends to defraud the plaintiff or a particular class of persons, or reasonably expects that class to rely on the misrepresentation.

KEY QUOTATIONS

> *"We conclude that an auditor owes no general duty of care regarding the conduct of an audit to persons other than the client."* (at 376)

> *"For the reasons stated above, we hold that an auditor's liability for general negligence in the conduct of an audit of its client financial statements is confined to the client, i.e., the person who contracts for or engages the audit services."* (at 406)

> *"Such persons are specifically intended beneficiaries of the audit report who are known to the auditor and for whose benefit it renders the audit report."* (at 407)

FACTUAL BACKGROUND

Arthur Young audited Osborne Computer Corporation's 1981 and 1982 financial statements and issued an unqualified opinion that the statements complied with GAAP and fairly presented the company's financial position. Investors, including Robert Bily and the Shea plaintiffs, purchased stock or warrants after relying on the 1982 audit opinion. The company subsequently experienced operational and market problems, its planned public offering failed, it declared bankruptcy, and plaintiffs lost their investments. Expert testimony identified alleged audit deficiencies and approximately $3 million in understated liabilities.

PROCEDURAL HISTORY

Plaintiffs filed separate actions in Santa Clara County Superior Court, and the cases were consolidated for trial. The jury rejected fraud and negligent-misrepresentation claims but found Arthur Young liable for professional negligence and awarded approximately $4.3 million in damages. The Court of Appeal affirmed on the relevant issues. The Supreme Court reversed, directed judgment for Arthur Young against Bily, and remanded for resolution of the Shea plaintiffs' cross-appeal concerning alleged aiding and abetting of fraud.

DISPOSITION

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reversed_and_remanded
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REMAND INSTRUCTIONS

The Court of Appeal was instructed to direct judgment in favor of Arthur Young and against Robert Bily. It was further instructed to decide the Shea plaintiffs' cross-appeal concerning the alleged aiding and abetting of the company's fraud and then direct judgment or further proceedings consistent with the Supreme Court's opinion.

CASES CITED

- Ultramares Corp. v. Touche, 255 N.Y. 170, 174 N.E. 441 (1931)
- Glanzer v. Shepherd, 233 N.Y. 236, 135 N.E. 275 (1922)
- Credit Alliance v. Arthur Andersen & Co., 65 N.Y.2d 536, 483 N.E.2d 110 (1985)
- International Mortgage Co. v. John P. Butler Accountancy Corp., 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986)
- Biakanja v. Irving, 49 Cal. 2d 647, 320 P.2d 16 (1958)
- Dillon v. Legg, 68 Cal. 2d 728, 441 P.2d 912 (1968)
- Thing v. La Chusa, 48 Cal. 3d 644, 771 P.2d 814 (1989)
- Roberts v. Ball, Hunt, Hart, Brown & Baerwitz, 57 Cal. App. 3d 104, 128 Cal. Rptr. 901 (1976)
- Goodman v. Kennedy, 18 Cal. 3d 335, 556 P.2d 737 (1976)
- Garcia v. Superior Court, 50 Cal. 3d 728, 789 P.2d 960 (1990)
- Harris v. Capital Growth Investors XIV, 52 Cal. 3d 1142, 805 P.2d 873 (1991)
- United States v. Arthur Young & Co., 465 U.S. 805, 104 S. Ct. 1495 (1984)